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STATE POLICY REPORTS

VOLUME 10 ISSUE 3

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February 1992 (First Of Two February Issues)

THE STATE OF THE STATES

Introduction

In January, most governors addressed their legislatures on the state of the state. The governors use this message as a forum for their report on how things are going, an opportunity to repeat the central themes of their administration, and a chance to outline their legislative program for the coming session. Some also use it as a place for their budget recommendations. In these broad terms, the state-of-the-state messages this year weren't much different from those of other years.

Many governors, probably looking back at what they said last year, lauded the success of Operation Desert Storm and commented on changes in the world following the breakup of the Soviet Union. Comments on the overall condition of the nation's economy, international economic competition, and hardships associated with the recession were common.

Some legislative leaders deliver substantive messages at the beginning of sessions or deliver formal responses to the governors' messages. Leaders' responses to a survey on priorities were compiled by the National Conference Of State Legislatures (NCSL) in its 14-page Leaders' Outlook 1992: Top Priorities For State Legislatures.

Federal Issues

The governors engaged in a substantial amount of bashing of federal action and inaction on such subjects as management of the nation's economy, non-responsiveness to human needs, regulation, and mandates. Governor Cuomo quoted former New York Governor Franklin Roosevelt who said in his state-of-the-state message 60 years ago, "In any state of this union of states, the complete solving of those economic problems which are national in scope is an impossibility without leadership and a plan of action by our national government."

The NCSL survey suggested:

> *In a word, they [legislative leaders] are angry. With broad consensus, they condemned federal policymakers for causing or compounding state fiscal distress with unfunded mandates in general, and expanded Medicaid obligations in particular; by aid cuts to local government; by failure to deal responsibly with the federal deficit; and by failure to lead the country out of economic recession.*

While there was criticism of federal policy, the state-of-the-state message emphasis was not on looking for federal solutions. Instead, governors stressed what states could do in the context of the economy and federal policy.

Challenge In Adversity

The governors talked about the economy, its impact on people and on state budgets. The situation was often described as challenging. Governor Wilson said, "We must transform this season of crisis into the greatest season of reform in California history." Governor Cuomo said, "We must build a New York with our own hands, without waiting for Washington." Governor Castle's comment is that an economic downturn "isn't all bad. It's good for government to contract. It tightens up efficiency." Governor Bayh organized his entire message around the challenge theme, starting this way:

My friends, we meet at a time of tremendous challenge for our state. We face:

the challenge of providing quality education to our children so they may prosper in the 21st Century,

the challenge of developing good job opportunities and preparing a workforce trained to fill them,

the challenge of a federal government that in matters large and small takes unfair advantage of Indiana,

the challenge of a health care system too costly, inefficient and closed to the middle class,

the challenge of protecting our land, air, and water from those who would pollute them.

Tonight, we face all these challenges and more. My friends, let us treat these challenges as opportunities.

Making Do With Less

The challenge theme appeared in detail when governors talked about their budgets. Squeezed by their own determination to avoid, or at least minimize, tax increases, sluggish revenue growth, and deficits or other problems left from prior fiscal years, they discussed ways to manage better. As Ohio's governor put it, "We're going to have to work harder and smarter and do more with less." Rhode Island's governor talked of the need to "cut to make room" for higher priorities.

Children

Doing more and better in dealing with children was a theme in many messages. It was the centerpiece of the Pennsylvania message. The theme provided a basis for governors to talk about expansion of health services for children (partially federally mandated), preventive health, education, foster care, and prevention of child abuse.

Looking Good, The Exceptions

Governor Mickelson noted in his state-of-the-state that, unlike other legislatures, the South Dakota legislature would not need to spend the year on issues of survival. He devoted much of his address to chronicling the successes of individual businesses operating in the state and to success statistics like rapid employment growth and low unemployment. His major revenue proposal is to increase the state's take from gambling. The money would be used for property tax relief. Despite prosperity, the state has felt the forces causing greater Medicaid participation, with a recent increase in caseload from 32,000 to 52,000.

In Idaho, revenues continue to show rapid growth, ruling out any possibility of tax increases. The major fiscal concerns arise from changes in policy, not current policy: (1) a promised sharp increase in state school aid, (2) state takeover of indigent medical costs from counties, and (3) an initiative proposal to limit property taxes. Another major issue will be how to cope with the state's rapid growth, with local impact fees a possibility.

HOT ISSUES OF 1992

Hot Issues And Important Issues

Every year sees *hot issues* in the states. Some, such as school finance and employee pay, reappear because new decisions must be made each year. Others, like capital punishment and abortion, reappear because the public and legislators are closely divided about issues that they consider too important to compromise. Yet others, such as crime and dependency, reappear because the underlying problem isn't solved. These kinds of issues are the basis for media lists of hot issues NCSL's 116-page summary of its survey of legislatures, State Issues 1992: Priority Issues For State Legislatures, 1992.

There are also *important but less publicized issues* that affect millions of people in major ways, move billions of dollars, and from many perspectives reflect where state officials are having their biggest impacts. Many of these highly complex issues are understood and decided by small numbers of people largely ignored by the media. Reimbursement rates for health care providers, school aid distribution formulas, and how utility costs are shared between industrial and residential customers are examples.

Straightforward Budget Issues

The budget will dominate everything.

There's no forum in government to discuss forward-thinking ideas. Everything is built on budgets, and we make next year's budget by looking at last year's.

These kinds of comments are being heard in nearly every state as elected and appointed officials recognize how little space for policymaking exists in a tight budget year. It is particularly frustrating when their ideas are rejected by general decision rules like "no new initiatives" or "freezing spending at last year's level."

The first quote is from the Senate Majority Leader in Arizona. It faces a shortfall in its current budget, a shortfall in the current services budget for FY 1993, and a structural deficit for the 1990s. The legislature will be dealing with a no-new-tax governor and an environment of distrust of elected officials created by the recent impeachment of a governor and resignation of legislators associated with a nationally publicized bribery scandal.

The second quote is from the resigning superintendent of North Dakota's only state mental hospital, who is taking a job in Idaho. His concern is not so much money as his inability to close the facility, which once housed 1,000 patients but now has less than 300, and concentrate on community mental health care. He estimates that the cost per patient-year for residential treatment is now over $100,000.

Pulling Issues Into The Budget Process

There is no precise definition of what is a budget issue and what isn't. One operational definition suggests four tests. People are more likely to consider something a budget issue as it meets more of these tests: (1) the executive branch position is decided during the preparation of the budget, (2) decisions are reflected in budget amounts and appropriations bills, (3) the appropriating committees have some role in passage of the relevant legislation, and (4) no matter what process is followed in substantive legislation, the impact can be altered or reversed in appropriations legislation. In most states, this makes welfare, school finance equalization, and health care financing budget issues.

When policy decisions become expensive enough to disturb a legislature's ability to fund its major priorities, decisionmaking power may shift toward appropriating committees. This means shifting the vehicle away from separate bills and toward the omnibus budget bill used in some states or the budget "trailer" bill(s) used in others. For example, in State Issues 1992, NCSL calls the budget bill "increasingly the context in which decisions on corrections policy are being made in the states."

Pulling issues like sentencing policy, education reform, employee benefits, and community versus institutional mental health into the budget process has many critics. They include individual legislators with more power in subject matter committees than fiscal committees, interest groups, and the media which finds the fiscal decisionmaking process less open to scrutiny. By procedural rules in legislatures and provisions in state constitutions, attempts have been made to limit the gravitation of issues to the budget process. Rules that each bill deal with a single subject are examples. These rules haven't prevented the gravitation because legislative leaders typically insist that legislators agree to support the entire budget package, however many separate bills it may contain.

Budgets Displacing Other Issues

Leaders' Outlook suggests lower priority treatment for non-fiscal issues of concern to legislative leaders like reapportionment, economic development, campaign finance, ethics, and Workers' Compensation. It comments:

> *These issues, which would otherwise be at the top of many legislative agendas have largely been displaced in most states by basic budget concerns due to depressed revenues and spiraling costs for core programs.*

The sections below summarize what's happening in some of the other issues that will likely dominate the non-fiscal portions of the 1992 sessions.

Education Quality

> *I think we'll prioritize and do the things that we absolutely have to do. Once you get past that, I'm not sure you've got any money left.*

This comment from the chairman of the education finance subcommittee of the Kentucky House typifies the situation of many states. In Kentucky's case, what absolutely has to be done is to fund the school aid formula and previously adopted reforms. There may not be room for more, such as a 5% teacher pay increase, an addition to the school aid formula rewarding local tax effort, and more money for pupil testing.

Reform measures will certainly be considered. They have political momentum. Immense media attention has been given to criticisms of public education. The President, governors, Members of Congress, and legislators are all committed to reform. Massive efforts have gone into designing reform measures through the many conferences and task forces that have been dealing with the subject in the business community as well as in the legislatures and among educators. So large numbers of people have a commitment to reform and a stake in the outcome.

The Link Between Reform And New Money

The education quality programs of the 1980s stimulated debate between professional educators and elected state officials. The educators said it was meaningless to talk about reforms and quality improvement without providing adequate basic funding and addressing such expensive issues as class sizes and teacher compensation. Using phrases like "pouring water into leaky buckets," some state officials insisted that education would have to reform before they would support major funding increases. The usual result was to adopt measures that combined new funding with new quality measures.

It will be tough to repeat this pattern. Leaders' Outlook concludes "The education reforms of the next decade cannot rely on additional funding for success; rather, focus must be on spending current dollars better." State Issues concludes, "The survey results indicate that virtually every state will address education reform in the 1992 session."

But reform measures incorporating significant (and thus controversial) changes face obstacles. Many educators aren't likely to buy into reform without new money. Many legislators, up for reelection, often in newly drawn districts, aren't going to want to alienate professional educators on issues like school choice. Fresh money is the glue that can build coalitions to surmount these obstacles, but it often won't be there. In Arizona, the governor talks about finances by saying, "We've run out of wiggle room." The chairwoman of the House Ways and Means Committee is predicting that school funds won't increase enough to cover inflation. The new chair of the Arizona Senate Education Committee summed up the frustrations, "I've waited 15 years to be chairman of the Education Committee and now we don't have the money to do things."

Workers Compensation

Employer costs for worker injury and disability insurance have been growing rapidly relative to other employer costs, even state and local taxes. This has drawn employer interest to holding down Workers' Compensation costs and created strong resistance from employers and those interested in state economic development to anything that would increase costs.

Meanwhile, organized labor has been concerned that: (1) the system costs too much for employers trying to compete with firms in other states and nations, (2) benefits are inadequate by standards of tort law recoveries for similar injuries, current pay, or what disabled workers and their families need, and (3) benefits don't go to workers when they need them. Administrative procedures and litigation chew up months, even years, and leave injured workers with large legal bills. As a result, WC was a big issue in 1991. NCSL's State Issues summarized:

> *Much of the debate in 1991 focused on skyrocketing costs and legislative proposals designed to address them. Medical cost containment, excessive litigation, administrative reform, permanent partial disability, vocational rehabilitation and the development of an integrated managed care system were hotly debated. In California and Maine, Workers' Compensation reforms were so controversial that they became pawns in fiercely fought state budget battles.*

The last sentence of this quote isn't correct. Workers' Compensation issues were considered so important that it was the budget that became the pawn. Those advocating a particular WC position were willing to hold up entire state budgets until they prevailed in WC. In NCSL's survey of legislative staffers, WC far outdistanced other candidates -- such as unemployment insurance, worker training, plant closing legislation, and family leave -- for labor issue of the year.

Environmental Issues

Many environmental issues involve state regulation of private and local government activities with no direct interaction with state budgets. Often environmental programs carrying a state cost are enacted with user charges that cover the cost. As a result, there will be less constraint on policymaking in this area than in many others. Issues include hazardous waste disposal siting, nuclear waste disposal, the regulatory implications of fuel switching by utilities, pesticides, and groundwater protection.

Municipal solid waste will be high on state agenda because several aspects of current policy have problems. Standards for landfills are having the effects of driving up disposal costs, encouraging use of out-of-state disposal (thereby creating issues in the recipient state), and exacerbating illegal dumping. Landfill scarcity becomes a real prospect as half the nation's landfills may be forced to close because they don't meet new requirements. Recycling has worked in part and failed in part, creating the embarrassing prospect of encouraging a sizeable portion of American households to separate waste that will be recombined in landfills. As NCSL puts it in State Issues, "Americans are willing to make the effort to recycle their used products, but are unwilling to purchase recycled products in the marketplace."

Air quality standards will be a major issue in the Northeast. Environmental protection officials of twelve states have declared their intent to adopt the more stringent California standards for tailpipe emissions from cars rather than adopt by default the less stringent federal standards. Clean water costs -- both for drinking water and sewage collection and treatment -- have largely been shifted to state and local governments though the regulatory pressures continue to be applied at the federal level. Local officials would rather have state help than rely exclusively on local bonding, fees, and taxes for compliance.

Health Care Financed With State Money

> *This session's going to center on the budget, and if you have legislation that costs money you're in trouble.*

The state-of-the-state messages suggest that state elected officials will find health care too great a concern to be ignored this year. One result in the legislatures, as in the messages, will be an outpouring of discussion of the problems -- high and escalating costs, persons without coverage, and health results showing little difference between the high-cost American system and lower cost systems in other nations. But beyond evidencing concern and knowledge of the problems, what will legislators do?

The problem is illustrated by Kentucky. The quote above is from the Chairman of the Senate Health and Welfare Committee. His immediate problem is passing legislation to preserve the state's current activities. They have relied heavily on bootstrap financing devices that, under the new federal legislation, will not be allowed after June of 1993. His solution is a gross receipts tax on health care providers, with a 6% rate now being discussed. The state also faces cost increases associated with higher costs per Medicaid recipient, the likelihood of more recipients of existing services, and the federally mandated extension of eligibility to certain pregnant women and children.

Utah, with a reasonably strong economy, is in a better position to pay for health care proposals than many states. But in its preview of the legislative session, the Salt Lake Tribune (1/12) concluded that activity in the session will center on the conflict over limited state funds between education and programs for the poor like welfare and Medicaid. Its conclusion in health care may prove an accurate prediction for many legislatures:

> *The national debate over skyrocketing health-care costs and shrinking insurance coverage will also move into Utah's Capitol. But beyond a serious plan to add $2 million to a year-old program to insure chronically ill people who can't get private coverage, lawmakers will likely do little more than talk.*

The governors of Colorado and Indiana are beginning the legislative session where some other states will likely end it -- appointing a blue ribbon commission not due to report until 1993. States have a long history of task forces, study committees, and similar groups designed to find solutions. Iowa's Governor's Commission on Health Care Costs was established in 1981. Its Health Care Policy Corp. was established in the early 1980s to unite consumers, providers, and employers. It lasted until 1988 when the providers withdrew. In late 1990, the Iowa Leadership Consortium on Health Care was established. It has been discussing a plan requiring at least $100 million in new state money while the governor and legislators have been discussing what they must cut to make good on their no-new-tax pledges.

Health Care Financed Without State Money

One result of concerns over financing health care will be an outpouring of proposed laws mandating someone to solve some problem: (1) telling health insurers they must cover particular services such as mammography or mental health, (2) telling employers they must pay for health insurance for their workers, (3) telling physicians and other providers that they must accept Medicare payments as full payment, (4) telling providers they can't turn away patients because they can't pay, (5) telling insurance companies they can't refuse to write policies or charge extra for them because (a) there are expensive prior medical conditions, (b) the type of business has a history of high claims, or (c) the applicant is a small business or a household.

Absent cost controls in health care, which have not been a popular topic except in the context of universal health plans, all these mandates cost somebody money to pay for somebody else's health care. Having the taxpayer pay through tax credits is popular with health care proposal writers, but isn't doing well in the legislatures. Mandating a substantial levy on employers to be paid to health insurers ("play") or tax collectors ("or pay") is having the same problem.

Without these aspects, the mandates, even when couched in innocuous language like risk pooling, must be paid for out of someone's pocket. The candidates: (1) employers willing to pay for their own employees but not others, (2) organized workers who see costs put in their employer's bill as likely to reduce what they can achieve in wages and benefits, and (3) health care providers. These groups are more comfortable exercising their clout in the legislative process than going on television to explain why they don't like mammography or why they think cancer patients shouldn't get health insurance. As a result, health care legislation is likely to get considerable attention, but major enactments appear much less likely.

An Ohio proposal indicates how the process can develop. Its January 19 status was summarized by Columbus Dispatch statehouse reporter Mary Yost:

> *A fast-moving health care reform bill will be reigned back a little this week while proponents rethink provisions that came under attack last week.*

The concept is to improve insurance availability by mandating changes in insurance -- making it harder to deny initial coverage and to end coverage of small business, restricting how much pre-existing conditions can be excluded, and putting a ceiling on rate increases. Ohio's governor endorsed the bill in a November news conference, but with what some might have considered a minor detail to be resolved but which is a massive caveat in such proposals. The endorsement was conditioned on waiting for results of an actuarial study to determine the premium increase other employers would have to pay.

At the time, this number was assumed to be in the broad range of 2-9%. The actuarial study raised the range to 8-12%. A Blue Cross witness at a January House committee hearing sought to raise the number to 21%. These numbers were large enough to raise concerns that the bill would cause some employers to drop existing coverage, make Ohio industry and workers less competitive, and create a political backlash from organized business and labor. The House bill will stay in committee for more hearings and consideration of amendments.

Crime Control And Criminal Justice

Sentencing policy is likely to be the #1 criminal justice and law enforcement issue this year, according to NCSL's survey. But the preferred direction of policy change isn't obvious, so there may be little change. Reducing crime by making sentences stiffer doesn't appear to have made much of a dent in crime rates, though it hasn't lost its intuitive appeal. It has made a dent in state budgets, taking corrections from 1% of general fund spending to 5% in a decade.

Rising costs and doubtful effectiveness of longer sentences have made alternative sentencing proposals (e.g., shock probation, shock incarceration, community alternatives, early release) interesting. But there isn't enough experience with these alternatives to give legislators confidence in them. The obvious risk is that they will result in well-publicized heinous crimes by some people put on the streets by the new policy.

New York's law requiring a mandatory prison term for second-time felony offenses is an example. It affects primarily small-volume drug pushers who are themselves addicts. The governor called for repeal last year, but the legislature didn't act on the proposal.

As usual, there will be some issues in defining crimes and punishments that will attract media attention. Examples: assisted suicides, negligently leaving a gun where a minor has access to it, abortion, and capital punishment.

Transportation

It could be a quiet year for transportation legislation. State legislative action doesn't appear to be necessary this year in response to the major federal legislation passed last year, as North Dakota discovered by scheduling a special session and then deciding it wasn't necessary. Governors and legislators trying to maintain a no-new-tax or no-major-new-tax posture will skip action on gas tax increases until next year if they can. Some legislatures will be forced to discuss old mandates (e.g., motorcyclists' helmets) not yet adopted.

Regulatory Issues

Legislators have a potentially full platter of regulatory issues. Regulating solvency of insurance carriers, tort law reform including limits on punitive damages, and control of public utility rates, services, and competition are just a few. Although not necessarily the most important by any standard, the telecommunications issues are likely to capture media attention. The issues include regulating pay-per-call ("900") services, caller ID services, telemarketing, "junk fax," and rates.

Political Process Issues

Issues relating to the process of making decisions and the selection of decisionmakers are likely to highlight non-fiscal issues in most legislatures. More than half the states have **redistricting** to consider this year, a number that is likely to grow with court rejections of previously adopted plans. **Campaign finance** measures will be at issue in at least half the legislatures with sessions this year. The issues remain contribution limits, disclosure rules, and possible public financing.

Term limits have drawn interest nearly everywhere. **Ethics** measures are again on the agenda with particular urgency in states where there have been recent well-publicized problems. South Carolina reacted last year with a special session that produced a 151-page bill covering financial disclosures, lobbying rules, ethical standards, and mechanisms to enforce them.

Economic Development

> *We have learned that we are not living in splendid isolation. The real world for California is that we are in strong competition not only with other states but with other nations.*

With these words, Governor Wilson launched the Council on California's Competitiveness to be chaired by former baseball commissioner Peter Ueberroth. The blue ribbon advisory group will consider issues like Workers' Compensation, liability reform, and education. There are similar groups in many states, some formal and some informal. But there don't seem to be major legislative packages bundling together economic development funding, regulatory reform to benefit business, holding down insurance costs (e.g., unemployment, liability, and Workers' Compensation), providing relocation incentives, and reducing business taxes. Instead, proposals on these subjects are generally being offered and considered issue by issue.

Hottest Issues Of All

If the hotness of issues is appropriately measured in thermal degrees, then Idaho has the hottest issues of any state. They triggered a Statehouse fire that caused some $1.5 million in damages. By the same criterion, Michigan has the coldest issues based on the December rains that penetrated a leaky roof and damaged the governor's mansion. The tendency of hot topics to be centered on the budget is suggested by the fact that the Idaho statehouse conflagration was concentrated in the offices of the legislative fiscal staff.

Coldest Issue Of All

Problems of general purpose local governments (cities, counties, townships, and parishes as distinct from school districts) are likely to get least attention, to the consternation of local elected officials. They want more money from states, which most states aren't in a position to provide. Leaders' Outlook suggests that budget cuts are more likely for local aid than other major state activities.

Absent more state money, the local officials want more local taxing authority. The prospects for it may improve as other alternatives become increasingly discredited. Legislators aren't keen on taking the heat for balancing their state's budget without new taxes and also taking the blame for permitting local tax increases. Some governors -- such as Engler in Michigan, Weld in Massachusetts, and Wilson in California -- have extremely strong stands against increasing local taxing authority. Some such as Engler and Edgar in Illinois are pushing for new limits on local taxing authority.

Local officials also want relief from what they see as costly state mandates. There is some activity on this front, such as an attempt to repeal prevailing wage requirements in Massachusetts. But the big ticket mandates on drinking water, sewage treatment, and solid waste disposal are mostly federal mandates published on state letterheads.

Is This Trip Necessary?

Why not simply cancel all the scheduled legislative sessions this year? The idea isn't totally crazy. No regular sessions are scheduled in Arkansas, Montana, Nevada, North Dakota, Oregon, and Texas. In some states, like Indiana, the major legislative session is in the odd numbered year following elections and only a "short session" is scheduled in even numbered years. It is widely believed that a substantial segment of the public feels safer with legislatures not in session. Many citizen-legislators neglected their regular jobs last year because of lengthy sessions and the complexity and intensity of budget negotiations. Many legislators, particularly those in redrawn districts, want to spend lots of pre-election time with constituents.

When the dust settles, there will be relatively close convergence between what legislators absolutely had to do and what they did. Some legislation not on the must-do list -- such as comprehensive education reform, Workers' Compensation reform, and new health care finance initiatives, may not get done in many states. The must-do list seems to be short, except for the budget. Redistricting and/or ethics are musts in some states, but settled issues in others. Federal legislative changes have made revisions in Medicaid bootstrap financing a must in some states and a good idea in others. The revisions won't always be popular. They will likely be treated as part of the budget package nearly everywhere, thereby attracting the end-of-session urgency, leadership support, and votes needed.

FISCAL UPDATE

Introduction

State fiscal circumstances haven't changed since the reports in Issue 1 and 2. That's bad news. The national economy and state revenues haven't revived. Over-budget spending rates in AFDC and Medicaid continued. Current state spending exceeds revenue nearly everywhere. Between the holiday season and waiting for governors' budgets, there was essentially no action to close these gaps between December 15 and the end of January.

Latest Summary Information

The latest National Association of State Budget Officers survey, (Looking For A Light At The End Of The Tunnel) confirms the situation revealed by the legislators' survey covered in Issue 2. Words:

> *It isn't that the [revenue] estimates were overly optimistic; the economy is simply not performing at its expected level.*
>
> *While the recession is the main source of state fiscal stress, it is certainly not the only source.*
>
> *As their fiscal crises continue, states are now much more focused on longer term solutions ... States now perceive this downturn to be not just a matter of surviving a recession, but a matter of restructuring state government.*
>
> *The expectation ... is that there will be less inclination for states to rely heavily on tax increases [than in 1990 and 1991].*

Persistent deficits and the instability they cause may begin to give way to efforts to restructure, redefine, and reorganize state service delivery systems and the very services states deliver.

The numbers in the NASBO survey understate problems because four states didn't respond and California's response excluded key numbers, such as its deficit. Numbers:

States with Gaps in FY 1992 Budgets	27
Size of Reported Gaps in FY 1992	$5.8 billion
Size of Reported Gaps in FY 1993	$7.9 billion
Program Most Often Exempted From FY 1992 Cuts	AFDC, 9 states
Program Least Often Exempted From FY 1992 Cuts	Higher Ed., 2 states
Program Most Often Getting Extra FY 1992 Money	AFDC, 19 states
Program Least Often Getting Extra FY 1992 Money	Higher Ed., 2 states
States Considering Budget Cutting Strategies	
Eliminate Or Reorganize Programs	21
Layoffs	14
Reduce Local Aid	13
Furloughs	6
Privatization	4
States Admitting To Considering Tax Increases	4

The Losers

Higher education and general purpose (non-education) local governments appear the likely losers in the state budget battles of 1992. The state-of-the state messages didn't say this, but mentioned them much less than in past years. They are low on budget officers' lists for added money and high on the lists for subtractions. Leaders' Outlook says: "Cities that rely upon legislative appropriations for revenue sharing or other types of unrestricted aid may face more hardship." A table in that report uses local aid as the standard for budget cutting, reporting the likelihood of cuts in eduction is 45% of local aid cuts and of cuts in Medicaid 70%. The table doesn't distinguish elementary and secondary from higher education, but the text comments, "Higher education in particular may be subject to cuts."

Accelerating Capital Outlays

Some of the governors discussed ways to stimulate state economies in their state-of-the-state messages. Most called for doing better with existing resources (e.g., education results) rather than new programs. Some sought job stimulating programs, including proposals for new bond issues. At least one governor has given the proposals a title, "GEORGIA REBOUND."

While financing new capital outlays with bonds is an attractive way to accelerate economic recovery, it can bump into fiscal and political constraints. The fiscal constraint is clearest in states that have relied heavily on bonding in the past. One example is New York, where the governor recently announced that the state will abandon the practice of committing to five year plans for transit investments. Local transit officials contend that the absence of this commitment will impair their ability to obtain federal funds, though this isn't obvious to the governor's staff (or **Reports**).

Another example is New Jersey. In his state-of-the-state message, Governor Florio stressed state spending to spur recovery. But the plan avoids new financing from taxes or general obligation bonds. Money will come from: (1) sale of the state's interest in the World Trade Center buildings to the Port Authority of New York and New Jersey, (2) housing revenue bonds, and (3) existing transportation trust fund sources like the gasoline tax.

THE ASSAULT ON WELFARE DEPENDENCY

The growth in these programs has fueled tax increases, taken money away from road repairs and schools, and caused a structural imbalance in our budget that threatens our very ability to provide for people.

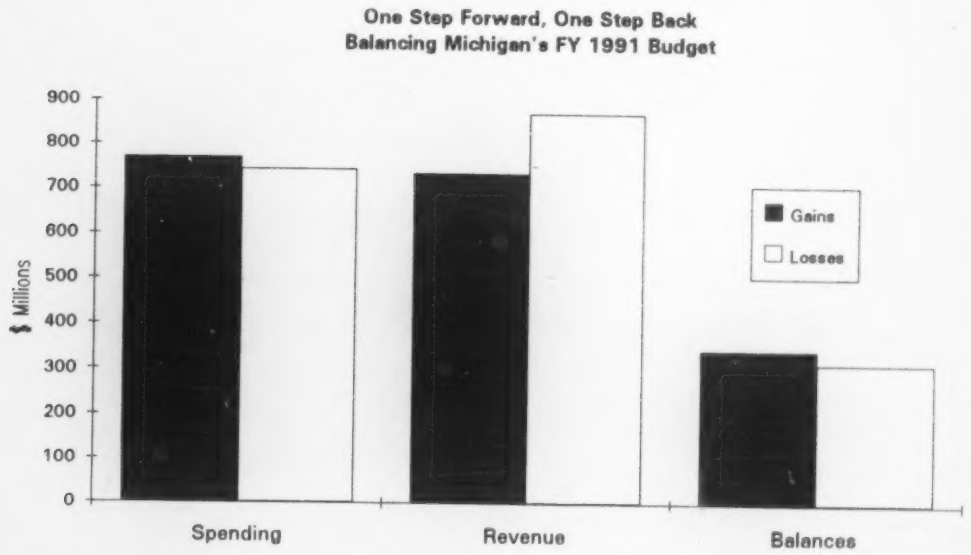
This line, from the New York Senate Majority Leader's response to the state-of-the-state message, is typical of increasing concern that welfare and Medicaid costs are squeezing all other state spending. This concern has been the main sticking point in trying to reach agreement on how to rebalance New York's FY 1992 budget.

Welfare Threatening Other Funding

Rapidly growing spending for welfare and Medicaid are forcing decisionmakers to consider changes in welfare policies. Elected officials are increasingly aware that, in a no-new-tax environment, having state income-tested programs grow by more than 10% while total spending grows 3-5% means education must grow less than 3-5%. The problem is hard to hide. Again this year, legislatures will be voting more money for welfare in supplemental appropriations at the same time they consider cutting other functions.

Budget Competition In Michigan

The problem with traditional budget adjustments is indicated by Michigan's actions to close its FY 1991 deficit of $1.9 billion, as shown on the chart. The complex series of budget adjustments boils down to cancelling spending overruns with spending cuts, cancelling revenue shortfalls with revenue increases, and offsetting negative balance adjustments with positive ones.



Additional appropriations (supplementals), primarily for income-tested programs like AFDC and Medicaid, raised spending by $743 million over the originally enacted budget. Appropriations reductions of $769 million were part of the budget balancing. So what was saved by spending cuts was about equal to what was lost by spending overruns.

The recession and other factors cut revenues $743 million below expectations, but one-time revenue items of $540 million and Medicaid bootstrap financing pumped an extra $734 into the budget. So revenue losses were about equal to revenue gains. Closing the books on FY 1990 brought $315 million of bad news into the year, but deferring some higher education spending moved $114 million in bad news out while tapping the rainy day fund moved $230 million of good news in. So adjustments to balances among years and among funds just about cancelled.

While nearly a wash in each of the budget categories, the changes weren't a wash program-by-program. The winners were the income-tested programs while other programs lost. As the problems carried forward to FY 1992, other programs were threatened again, along with taxpayers.

Because Governor Engler was committed to protecting both the taxpayer and education, his response was a cut in welfare. Michigan legislators were reluctant to accept the recommendations, but even more reluctant to accept the alternatives. The same forces explain themes of governors' budgets in California, Massachusetts, New York and elsewhere.

Cuts In Welfare Becoming More Common

The result is being seen by the media as a nationwide movement. This is indicated by headlines like "Surging Welfare Costs, Struggle To Control Them Join Health-Care Expense As Hot Political Issue (Wall Street Journal, 12/11), "States Yank Welcome Mat On Welfare" (Chicago Tribune, 1/11) and "California Plan To Cut Welfare May Prompt Others To Follow" (New York Times (12/13). Journalistic accounts usually cite Illinois, Maryland, Massachusetts, Tennessee, and Vermont, along with California and Michigan.

Cutting General Assistance

General assistance is cash provided by states (and in some states by local government) to persons who don't meet the tests for eligibility for federal-state programs -- persons who don't have children and aren't aged, blind, or disabled. Michigan's cutback last year got national publicity. There were also major cutbacks in Massachusetts, Ohio, and other states. A common cutback is to restrict the number of months a person can receive assistance.

Cutting AFDC Benefits And Eligibility

Most states have been cutting back on the purchasing power of AFDC benefits for two decades, partly because increases in Food Stamps and low-income energy assistance have taken up some of the slack. Last year, California cut its higher-than-average benefits. This year, Governor Wilson is taking an initiative package to voters in November. It contains proposals unlikely to be approved in the legislature -- a 10% benefit cut, a further 15% benefit cut for able-bodied recipients who don't find work, and a ceiling on benefits for new residents. They could receive no more than what they would have received in the state from which they migrated. A similar restriction on payments for new residents has been recommended again this year by governor Thompson for Wisconsin.

There are several proposals to discourage welfare recipients and potential welfare recipients from having children. The California proposal prohibits minors from getting state money to set up housekeeping by requiring that they and their child stay with their parents except in special circumstances. The lame duck session in New Jersey passed a measure that reduces grant increases for children born while the mother is already on welfare.

Cutting Special Needs Allowances

Each state's monthly welfare benefit is a known amount. It appears on a recipient's check and can be accurately tabulated to produce average and maximum payment statistics of the type that appear in States In Profile. Recipients also are entitled to Food Stamp vouchers and Medicaid coverage and may qualify for programs like subsidized housing, job training, and day care.

In addition, most welfare recipients get low-income energy assistance paid for by federal money, dedicated proceeds of certain price overcharge settlements with oil companies, and state funds. Cash is also paid to recipients or to vendors in many special needs situations that vary from state to state. Payments cover such needs as winter clothing, security deposits on apartments, replacement of appliances, moving expenses, extraordinary housing costs, and more. Because of considerable variation in these payments and the absence of reporting for them, it is hard to track changes in their use.

Fiscal pressures and a desire to disengage social workers from the day-to-day decisions of recipients have produced interest in eliminating or curtailing special needs programs. Michigan is an example of a state that has done this while Rhode island may become an example of a state doing it this year.

Look Twice At Welfare Reform In New Jersey

> *What this does is give welfare recipients a choice. They either can have additional children and work to pay the added costs, or they can decide not to have any more children. It's their call and a decision that puts them in the same position as anyone else in mainstream America who must choose among options.*

This is the New Jersey House Majority Leader's description of a newly adopted plan to prevent increases in welfare grants for welfare mothers who have more children. While this idea has been discussed in many states, New Jersey is the first to pass it.

It is easy to dismiss New Jersey's welfare reform package. It is "welfare reform" which makes it sound like other reform proposals such as those in California, Michigan, and Wisconsin. It was passed in a lame duck session with a Democratic majority that has now become a minority. It wasn't the main act or even a widely noted sideshow in a session marked by attempts to repeal the Garden State's major tax increases and by a constant battle by Democrats to keep a quorum and by Republicans to prevent one.

Politically, the package had something going for it. Its leading proponent was a Democrat, a legislative leader (House majority leader), and a representative of an area (Camden) that has about the largest percentage of welfare recipients and the lowest incomes in the state. It was supported by large bipartisan majorities despite opposition from church groups, the American Civil Liberties Union, and others. The main bill passed the Senate and moved to the governor's desk by a vote of 27-1. Controversial provisions subject to separate votes passed by margins of 22-4 and better. The governor signed it enthusiastically, commenting, "This ought to be a policy nationally." He criticized the current welfare system as "corrupt" and "morally bankrupt."

The legislation was sold as being pro-family and not punitive. The intent is more to save families and children than to save money. The major savings are associated with denying an increase in cash benefits for a mother having children while on welfare. Medicaid and Food Stamps would both cover the added child. There is also a work requirement, but like other work requirements its impact will depend upon implementation.

A key change is in treatment of additional household income. Wayne Bryant, the key sponsor, describes current law as a marriage penalty, which it is. For complex reasons, he argues there is now a penalty on married non-working parents. New Jersey, and other states, consider the income of a new husband in determining household need. So when a woman on welfare marries someone with a job, both the welfare payment and associated benefits are lost. The new law would, in effect, disregard his income up to certain thresholds, such as $20,100 for a family of four.

The bills violate many federal welfare rules, so waivers will be required. Bryant, who has met with White House officials on the subject, expects approval this spring.

SCHOOL FINANCE EQUALIZATION

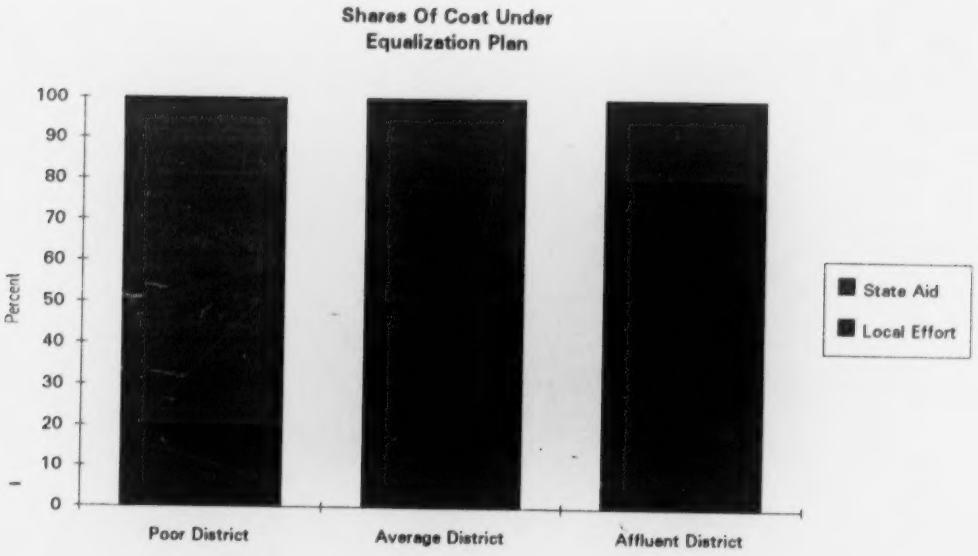
School finance reform is like a 19th Century Russian novel. The story line runs across generations, the plot is complex, the prose is tedious, and everybody dies in the end.

Controversies over school aid equalization will be affecting state decisions this year in many ways, with considerable variation among the states. The political hazards are captured by the quote above which is often heard in discussions of the subject.

It is hard to overestimate the impact of equalization issues on state finances. Much of the impetus for New Jersey's tax increases came from equalization. So did recent tax increases in Kentucky and Texas. Fear of court-mandated equalization is a major factor encouraging Tennessee to adopt an income tax this year. NCSL's survey of legislative leaders indicated at least 18 states will debate school aid formula changes this year. About half the states are engaged in litigation over the equity of their school aid formulas.

How Equalization Works

Every state makes some attempt to equalize the spending ability of districts of differing wealth. The concept is illustrated by the chart. The local effort component is defined by a logic, such as a property tax of 1%, applied to each district to determine what it should raise. The minimum program is defined by another logic, such as so much per pupil. State aid fills the gap between the minimum program and the local effort.



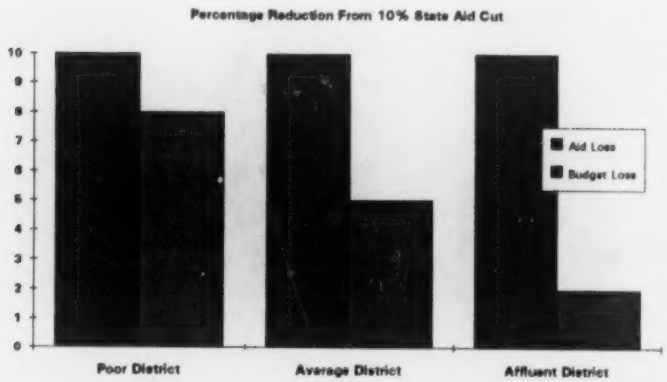
Controversies Over Equalization

Against the standard of equal per pupil spending capacity for districts of differing affluence, most state equalization plans are subject to attack -- on equity grounds in the legislature and on constitutional grounds in the courts. The equalization standard is violated in many ways. Some "out of formula" districts are so affluent that they can spend more than the state standard with a lower tax effort than required by the formula even when they get no state aid at all. For these districts and others, the formula's logic is violated by hold harmless provisions and guarantees of minimum per pupil amounts. Major cost categories, such as school construction, are often left out of the formula. Some states don't consider differing local tax capacity when paying certain costs, such as teacher retirement and special education, outside the formula.

To complicate matters, there are differing views on the appropriate ways to measure elements in a formula. Measuring local effort by the property tax base is common, but doesn't reflect differences in ability to pay as measured by income. It may be unfair to consider two districts equally just because they have equal tax bases if one shares the base with an expensive central city while the other is in a rural area. There are also controversies over measuring the minimum program the state guarantees. For example, should high school and vocational students count more than regular students? Another problem is what to do with affluent districts that go beyond the minimum program by local vote. Should they be permitted to do this at all? If so, should they have to share their added revenues with other districts?

Equalization And Cutting The Budget

Equalization considerations are also creating controversies in the many states applying percentage cuts to much of their activity including across-the-board cuts in school aid.



As shown at the left, the impact of cuts on schools depends upon how much each district relies on state aid. A 10% aid cut causes only a 2% cut in the budget of the affluent district, a 5% cut in the average district, and an 8% cut in the poorest district. This arguably puts disproportionate hardship on the poor district and clearly defeats the logic of the state's equalization effort.

This issue is being faced by every state that has had to reduce school aid. It was addressed in Maine in January as part of the FY 1992 reduction package. The legislature decided to mute the impacts that would result from equal percentage reductions of state aid by making larger reductions in the more affluent districts. The same issues have been at stake in the Massachusetts cuts over the last several years. They are a part of the impasse over budget cuts in New York.

Raising School Aid

The issue of how to allocate additional money for schools arises each year. It has a special element in states that are seeking to move toward more equalization in school finance without litigation. In Virginia, the Coalition for Equity in Educational Funding has withdrawn its school finance lawsuit. Its leaders indicated they were responding to a "strong commitment" to school finance reform by legislative leaders. But there do not appear to be specific promises on formula changes and there clearly is no commitment to seek higher taxes to finance reform. Virginia legislators hinted they were less likely to act while a suit was pending than if there were no litigation. The state's plan will presumably provide larger increases each year for poor districts than for affluent ones until an equalization target is reached. Such a plan is more easily summarized than drafted.

Continuing Agony In Texas

> *Texas school finance is not a Russian novel. It's more like a Greek tragedy. The public schools are dying, and the means of salvation are at hand, but the gods who are supposed to watch over these things have lost themselves in bickering and evasion.*

This assessment from the lawyers contesting the latest Texas school finance plan summarizes some of the problems that continue to dominate the Texas budget, tax policy, and to a significant degree, politics. In prior chapters of the novel (or acts of the play), the state supreme court has rendered two equalization decisions. The legislature has sought to provide equalization by providing additional state money, including money from raising taxes, concentrated on poorer districts. It also produced billions of property tax increases by setting a minimum property tax level and spreading the property tax base from a district basis to a county basis. The plan went back to court with rich districts (the "Robin Hood Forum") challenging the county tax arrangement as a disguised form of statewide property tax that is prohibited by the state constitution.

The governor warned the state supreme court of possible school closings if it rejected the new plan. In commentary on a pending case that is unusual in most judicial systems, she sent a letter to each justice. Legislative leaders sent the same message by press release. The chairman of the House Education Committee suggested that if the court invalidated the current plan, it should figure out its own substitute plan. The governor's letter to the justices commented, "It would not be productive to call members back to Austin for a special legislative session again to address the issue of public school finance in an atmosphere of crisis and contention."

Besides this pressure, many justices face reelection in November. In a divided late January opinion, they decided that the new plan was an unconstitutional statewide property tax. But there will be no pre-election crisis. Districts can keep the money they collect and the legislature has until June of 1993 to enact a new plan. Devising a new plan acceptable to the court will be extremely difficult without resorting to one of two unpalatable alternatives: (1) seeking voter approval of a statewide property tax or (2) a massive infusion of new state money requiring highest-in-the-nation sales taxes or enacting an income tax.

TAX CUTS

While fiscal problems suggest tax cuts won't be a major state issue this year, there is some activity. Much comes through voter initiative measures, such as those in Colorado and Idaho. Among elected officials, interest in tax cuts has been confined primarily to proposed limits on local property taxes (e.g., Illinois and Michigan) and narrow business tax reductions (e.g., Delaware). The exceptions are Massachusetts and New Jersey.

The Second Massachusetts Miracle? Ending speculation on how he would handle a gap of more than 10% of the FY 1993 budget, Governor Weld proposed a $200 million increase in school aid and cutting: (1) the personal income tax rate, (2) the tax on capital gains, and (3) corporate taxes through several tax credits, including a credit of nearly 100% of the first-year employer cost of creating new jobs. Initial discussion centered on whether the mathematics of the budget was credible, rather than on the merits of the tax proposals.

Tax Repeal In New Jersey: The Democratic legislative majority passed a major tax increase that led to the Republican landslide in 1991. Most winning Republicans criticized the increase and promised to repeal the sales tax portion, but not the entire package. Democratic leaders tried to repeal the package. The new Republican majority could reenact the package, thereby becoming the party that raised taxes. The tax increase was earmarked for specific items such as school finance reform and property tax relief. When recession hit, state finances suffered despite the tax increase. The FY 1992 budget is balanced only with one-time items. With recession continuing and a need to replace revenue from the one-time items, one estimate of the FY 1993 budget gap is $2 billion out of a budget of about $15 billion. Legislators spent the better part of December and early January debating repeal. It passed one House but barely failed in the other as a few Democrats defected.

TECHNICAL NOTES

Workers' Compensation: As the annual indices reveal, Reports has often assessed WC reforms. More than in any field, other than capital punishment and selling state liquor stores, the issues don't seem to change, new analyses aren't providing new insights, and new data don't indicate new patterns or trends.

School Finance Equalization: The Russian novel quote probably originated with Denver-based school finance consultant John Augenblick who has helped write many of the state school aid formulas. The quotation on Texas school finance is from an OpEd by James George and Hugh Lowe that appeared in the Austin American-Statesman (12/20).

Corrections And Revisions: In the table comparing per capita tax burdens on p. 15 of Issue 1, all of the numbers and rankings are correct. So is the national average of $2,016, but it should have been inserted after the 16th state rather than after the 11th.

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STATE POLICY REPORTS

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IN THIS ISSUE

Governor Weld of Massachusetts is often drawing national attention. The reasons shed light on policy issues in all states. One reason is applying supply-side concepts to states, including pushing for tax cuts in a depressed economy. Another is emphasis on prevention, and the linked theme of investment. Yet another is "entrepreneurial government," the topic of a new must-read book. It offers concepts and phrases, like *empowerment*, that are becoming more popular in many states -- perhaps indicating a *paradigm shift* in how states are run.

- A Star Is Born p. 2
- Supply-Side State Policies p. 3
- Entrepreneurial Government p. 4
- Unleashing The Paradigm Shift p. 5
- Prevention And Investment p. 10

Paying for health care has become increasingly important to the public and to state and federal officials. All the evidence suggests that health costs will continue to consume larger and larger portions of the nation's income. State officials aspire to solve some of the resulting problems, but the solutions may prove beyond their reach.

- Financing Health Care p. 11

In the midst of mediocre to rotten economic and fiscal circumstances, one might guess that cuts in state taxes would be out of the question. There may be exceptions, mostly for business.

- Fiscal Conditions Update p. 17
- Tax Cuts For Business p. 18

Besides trying to stimulate development with business tax cuts, some states are using pension funds and idle cash. Doing this has risks, but so does not doing it.

- Investing Pension Fund Assets p. 21

Technical notes examine detail sources and caveats.

- Technical Notes p. 24

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February 1992 (Second Of Two February Issues)

A STAR IS BORN

When William F. Weld took office as the first Republican governor of Massachusetts in 16 years, he faced a hostile Democratic House and Senate, a dead-battery economy and a daunting budget deficit.

Thirteen months later, despite the misery of slashing government programs in recession, Weld is winning generally high marks for balancing the budget while holding firm on no new taxes. He also is proposing going one step beyond fellow governors by cutting taxes.

This Washington Post (2/12) assessment is typical of the national media attention Governor Weld has been receiving. Some of the attention is based on non-economic issues and politics. Weld's story is more intriguing because he is reversing policies of Governor Dukakis, the 1988 Democratic Presidential candidate, and because he is mentioned as a possible opponent of Senator Kennedy in 1994 and candidate for President in 1996. His support of abortion rights, gay rights, and the right to bear arms gives him interesting other positions to accompany his fiscal perspectives.

Most of the attention is because of his fiscal policies, a potential model for the nation. As the Wall Street Journal (2/5) put it: *If William Weld can end the tax-and-spend cycle in liberal Massachusetts, then surely the governors of more fiscally moderate states can recapture control of their states' budgets.*

Weld's tax-cutting record is perfect so far. In 1991, he induced the legislature to repeal the sales tax on professional services before any money was collected and obtained approval of research tax credits. He prevented the legislature from giving local governments new ways to avoid the property tax limits of Proposition 2 1/2 and from extending an income tax surcharge. So the tax dropped on schedule in January. His new budget seeks cuts in the personal income tax rate, capital gains taxes, and corporate taxes.

His budget offers what many governors would like to offer -- tax cuts, large increases in school spending, and a balanced budget after years of deficits. His standing in the polls, more than twice as many favorable impressions as unfavorable, contrasts with much lower popularity of governors like Wilson of California and Cuomo of New York.

National Recognition, A Blessing? Being a new governor spotlighted by national media, as Governors Weld and Engler (R, Michigan) now are, doesn't presage success in office. In the year after their election, Governors Mabus (D, Mississippi) and Roemer (D, Louisiana) were featured as a new wave of bright, well-educated governors leading their states to new heights in economic development and education while demonstrating modern management styles. Both were defeated in their 1991 reelection tries. In 1990, the governors with the widest reelection vote margins were ones that received little national media attention -- Campbell (R, South Carolina), Casey (D, Pennsylvania), and Andrus (D, Idaho).

SUPPLY-SIDE STATE POLICIES

If you believe in controlling growth of government, the best way to do it is to take away the revenue.

One of the ways to keep spending down is to keep money away from government.

Supply-Side Economics: Such comments were common in the early 1980s when the concepts of *supply-side economics* were being debated as national policy. They were reflected in President Reagan's first budget and tax recommendations which were largely adopted by the Congress in 1981 and have affected federal fiscal policy ever since. While there is more than one definition of the concept, one tenet is that government -- through taxes, spending, and regulation -- retards the growth-creating forces of the private sector.

In the imperfect world of government policymaking, reining in taxes and spending simultaneously isn't always possible, particularly when a supply-side chief executive is dealing with a legislative body that doesn't share his views. So the concept is to wrestle the tax-and-spend beast to the ground by grabbing whatever part can most easily be grabbed. Because public opinion supports spending more than taxes to pay for it, cutting taxes is a prescription for cutting government. The right taxes to cut are those on suppliers of labor and capital -- the personal and corporate income taxes, including capital gains taxes.

Supply-Side In The States: Cutting taxes with the idea that spending will eventually follow is tenable for the federal government, which can operate with unbalanced budgets. Because of balanced budget requirements, there isn't usually a need to distinguish between whether to cut state taxes and then spending or cut spending and then taxes. The movement for constitutional restraints on state and local finances produces what policy watchers call tax ***and*** spending limits. The distinction between limiting taxes and limiting spending is usually so unimportant that few people know which of the effective limits -- such as the Gann Amendment in California and the Hancock Amendment in Missouri -- limit spending and which limit taxes.

Supply-side rhetoric is appearing in the states this year, and getting lots of national attention. Governor Weld made the first comment quoted on this page when he was showcased, along with Governor Engler of Michigan, at a February seminar held by the conservative CATO Institute. The second quote is from Weld's press secretary defending his budget to the Boston Globe (1/23).

Supply-side perspectives are affecting the few tax cuts being considered in the states. They are concentrated on personal income taxes (e.g. Arizona, Massachusetts, and Pennsylvania) and corporate taxes (Massachusetts, Pennsylvania, and many other states).

ENTREPRENEURIAL GOVERNMENT

"Entrepreneurial government" is one phrase used to describe what the Weld Administration is trying to accomplish. Its Bible has just been published by the consultant/journalists (David Osborne and Ted Gaebler) who have been pushing its perspectives in Arkansas, Florida, Massachusetts and elsewhere. Reinventing Government: How The Entrepreneurial Spirit Is Transforming The Public Sector (Addison-Wesley Publishing) gets rave reviews from Governor Weld (*required reading in the Weld Administration)*, Governor Clinton (*should be read by every elected official in America*), and syndicated columnist Neal Peirce (*best primer yet on how America's governments can survive the fiscal agonies of the '90s*).

The book is more about management than policy, more about attitudes than individual decisions -- "It focuses not on what government should do, but on how government should work." As its dust jacket comments, "Reinventing Government is not a partisan book ... its ideas have been embraced by both liberals and conservatives, Democrats and Republicans."

The book, and Osborne's ideas, are getting enthusiastic press attention, typified by the headline in the New York Times (2/17), "Exponent of Government-as-Business Is Gaining Bigger Audience." The article credits Osborne with a decision by Governor Chiles that freed some of Florida's largest agencies from their cumbersome rules, quickly raising productivity. He is also given credit for money-saving changes in the Medicaid program in Massachusetts. Such reviews will draw even more interest in state capitols as readers see that reviewers like the Times perceive Osborne as offering painless budget-balancing:

> *What Mr. Osborne would do, at a time of widespread fiscal crisis, is to cut costs without eliminating essential services through a more imaginative and efficient approach to government. To some extent, he wants to make government run more like business.*

The 405 pages of Reinventing Government are highly readable. They are filled with real life examples, catchy phrases, dramatic quotations, analogies (e.g., "We need an American *perestroika.*") and nifty nice-sounding generalizations like, "we need *better* government. To be more precise, we need better *governance."* Rigor is the price paid for readability. Critical readers will leave the examples wondering whether anyone was opposed to what was done, why they were opposed, and if there was follow-up evaluation.

Some concepts may be new insights. Others wrap old ideas in new packages, which can help if good old ideas have gotten bad names by botched implementation. The concepts can be slippery in specifics. For example, Governor Weld is touting zero-base budgeting. Osborne calls zero-base "too cumbersome." The two are probably talking about different budgeting systems (See Technical Notes).

The book is like the passage from Governor Wilson's 1991 inaugural address quoted on its concluding page.

> *We will not suffer the future. We will shape it. We will not simply grow. We will manage our growth. We will not passively experience change. We will make change.* ***But to shape our future, we need a new vision of government.***

Both the book and the quotation have thoughts readers would agree with, though they might express them differently. But the book and the inaugural message lend more inspiration than guidance for dealing with the individual decisions faced in Wilson's California and elsewhere.

After finishing the book, readers are likely to ask, "now what specifically do I do to implement what I have learned?" They won't find advice on current budget-balancing issues like whether to slash general assistance rolls, cut universities and raise tuition, revise school aid formulas, or try to limit hospital reimbursement rates.

But the authors seem to have anticipated readers looking for specifics by providing a chapter that applies their principles to health care, education, and criminal justice. Readers looking for non-controversial, money-saving quick fixes will be disappointed. The three page discussion of health policy opts for the German system, including universal coverage through mandates of employer coverage and public subsidies for the unemployed poor. Education would be restructured by giving parents choices of schools with the hope that the result would be as good as Catholic schools which produce "far better results for far less money than comparable public school systems." Crime would be attacked by shifting power from separate systems of police, prosecutors, courts, and corrections to regional bodies resembling the Private Industry Councils now used for job training. These may or may not be the right prescriptions. They aren't easy fixes.

UNLEASHING THE PARADIGM SHIFT

> *In government after government and public system after public system, reinvention is the only option left. But the lack of a vision -- a new paradigm -- holds us back. We hope the vision we have laid out will unlock the remaining gates -- unleashing a paradigm shift throughout American government.*

This passage summarizes Osborne's hope that readers will unleash a *paradigm shift* {probably welcome news for those who previously worked for *sea change}*. Whether readers do this or not, they need to recognize the *vocabulary* of entrepreneurial government if for no other reason than to present their old ideas effectively. To do this, they need the "ten simple principles" of Reinventing Government summarized in the next four pages.

Used almost as a checklist, the ten principles offer a powerful conceptual tool. One can run any public organization or system -- or any of society's problems -- through the list, and the process will suggest a radically different approach.

CATALYTIC GOVERNMENT is governing by managing, not doing, *steering rather than rowing*. When governments do things, they are *monopoly suppliers* and become inflexible and inefficient. Government should be a buyer, not a performer, of services. Governments become *steering organizations* to deliver funds and evaluate performance. The key is *leveraging* private resources and using the private sector for what it does best, producing goods and services. This way governments can be *smaller but stronger*. There are 36 alternatives for doing this including *avant-garde* ones like *seed money* and *equity investments* by government. Progress will require forcing change on interest groups, such as teachers and doctors, to *restructure institutions and markets*.

Government should let *competition* energize its suppliers -- rewarding *experimentation* and *comprehensive solutions*, such as *holistic* strategies. Privatization, as a grand ideology, isn't right, but having things done by contract is. The thought that government and business should be separate is "an outdated mind-set." There are not just two sectors of the economy, private and public, there is the *third sector* of institutions that are private but don't exist to make a profit -- religious groups, Blue Cross, and United Way organizations. Like firms, they are potential performers of government work,

Examples: revitalizing St. Paul and Indianapolis, mental health in Ohio, Oklahoma Futures, and contracting out mental health in Arizona. Examples of what not to do: government payment of 40% of health bills without shaping the market and spending $500 billion on the savings and loan bailout without influencing where the money went.

EMPOWERMENT should appear through *community-owned government*. It is an American tradition already reflected in Little Leagues and Scouts, *self-help organizations*, but lost when government acts by creating programs, clients, and dependency. Ownership and control of public services should be pushed *out of the hands of bureaucrats and professionals, into communities*. Communities are better than professionals because they have more commitment to those served, understand their problems better, are more flexible and cheaper, enforce standards of behavior more effectively, and are oriented to solving problems rather than delivering services.

Examples: *community-oriented policing*, tenant committees in public housing, local school control in Chicago, the Arkansas home instruction program for preschoolers, paroling prisoners to the Salvation Army in Florida, the hospice movement, and job retraining in Massachusetts. What not to do: urban renewal, deinstitutionalizing mental patients but not funding and monitoring community care, and public housing.

COMPETITIVE GOVERNMENT *injects competition into service delivery.* Not competition among policy agencies (just turf wars), but competition among those delivering services. Not competition among individuals, like merit pay for teachers, but competition between organizations, like merit pay for schools. Competition leads to efficiency, more bang for the buck, and rewards innovation. Without competition, franchised private monopolies like public utilities aren't necessarily better than public monopolies.

Examples: Minnesota's school choice experiments and competition between public employees and contractors to collect trash in Phoenix and run Tennessee prisons. What not to do: the Postal Service and preventing auto insurance price competition in Massachusetts.

MISSION-DRIVEN GOVERNMENT is focused on objectives, not rules. It works while *rule-driven organizations* don't. Entrepreneurial leaders do away with obsolete regulations and programs. They use a *mission-driven budget system* rather than line items. They *marry their budget systems to performance measures.* They junk *rule-driven personnel systems.* They break large agencies into small groups by *chunking* and spin off new teams by *hiving.* They *reorganize around mission, not turf.* With a clear mission, *leaders build a culture around it.* They *create permission to fail.* Without it, authority is lacking to do things right.

Examples: a Louisville housing agency with no employees, quasi-public corporations for economic development and job training in Massachusetts, waivers of rules for school districts in Washington, and doing without a civil service system in Texas. What not to do: the two-volume rule book for New York City schools and state laws requiring upholstery tags to protect against problems with horsehair that hasn't been used in 50 years.

RESULTS-ORIENTED GOVERNMENT focuses on *outcomes, not inputs.* Hallmarks are *accountability, performance, and results.* Performance measurement is key because *what gets measured, gets done.* Asking nothing of welfare recipients except that they stay poor, *rewards failure* and *breeds dependency.* The solution is *mutual obligations,* building *demands for performance* into poverty programs. The public supports funding when *spending is conditioned on results. Management By Results* is better than old ideas like Management By Objectives or Management by Guesswork. *Total Quality Management* combines a results orientation with worker participation, making it "an extremely powerful tool." The budget system must be *mission-driven, decentralized, and results oriented.*

Examples: the Illinois reimbursement system for nursing homes, nine states that tie vocational education funding to placements, rate regulation that rewards utilities for operating efficiently, management through performance standards in Wisconsin, "Learnfare," and cooperation of the President and the governors in setting education goals. What not to do: federal drug enforcement programs, giving police departments more money when crime rates rise, and California with "400 commissions that spend almost $2 billion a year."

CONSUMER-DRIVEN GOVERNMENT replaces *one-size-fits-all services* with services tailored to meet individual needs by letting citizens choose and through consumer surveys and focus groups. *Putting customers in the driver's seat* can be done by giving them control of the purchasing decision through *vouchers* like Food Stamps or the GI Bill. *Customer-driven systems* force service providers to be more accountable, take politics out of selecting who provides services, promote innovation, match supply and demand, and give consumers choices. *Empowering consumers* promotes equity better than funding suppliers. For example, rather than funding state universities serving primarily middle and high income students, give equal value vouchers to all potential students.

Consumer-driven systems should be *user-friendly*, *transparent* (like electricity, so consumers don't have to figure out the bureaucracy to get the service), and *holistic* (dealing with the whole person and whole problem) with *one-stop shopping*, *single intake systems*, and *case management* systems. "A time will come when people won't believe that a pregnant high school girl in America once had more than a half a dozen different caseworkers" or parents "could not choose the public schools their children attended."

Examples: self-service computerized terminals for drivers' license renewals in California, a Wisconsin community college handled such problems as cancelled classes with modules of three weeks rather than semesters or quarters, and voucher-like devices for child care in Connecticut. What not to do: long lines at licensing agency offices and Governor Engler's decision to drop the Michigan job training system.

ENTERPRISING GOVERNMENT thinks about making money, not just spending it. It relies heavily on user fees and makes arrangements for the poor rather than subsidies for everyone. It has an investment perspective, *spending money to save money. Turning managers into entrepreneurs* can be accomplished by letting agencies and even employees share in the savings and earnings they generate, budgeting *innovation capital*, *enterprise funds*, and public authorities like airport authorities. These can become *profit centers* even competing with private business. To do this, governments need to know their *true costs.*

Examples: the money-making Los Angeles Olympic Committee, cities that sell sewage sludge and unfilled jail beds and share in real estate projects, investments in tax auditors and Head Start, and charging for responses to false alarms. What not to do: a Minnesota legal decision limiting royalties the state collects on software it developed.

ANTICIPATORY GOVERNMENT stresses *prevention rather than cure.* It anticipates problems and opportunities, rather than *lurching from crisis to crisis*. It uses *anticipatory democracy* such as futures commissions, employs *strategic planning* that *permeates the culture of an organization*, and makes decisions based on building *consensus.* This takes *long-term budgets* that marry budgets and planning and allow leaders to be *proactive rather than reactive*, *cross-departmental budgeting* showing one agency's impact on another's cost, accrual accounting with depreciation, and metropolitan governments.

Examples: fire prevention, gun control, prenatal care, new governors who "have made prevention a central theme," preventing homelessness in New Jersey, budget projections in California and Florida, and fiscal notes. What not to do: getting into debt and a Florida long-range planning system which "quickly degenerated into makework."

DECENTRALIZED GOVERNMENT moves *from hierarchy to participation and teamwork* because decentralized institutions can respond better, be more innovative, and have greater morale. Entrepreneurial leaders *return control to those who work down where the rubber meets the road* by *decentralization* and *participatory management* including *site management* like pushing authority from school districts and state agencies to schools.

These leaders improve labor-management relations, recognizing much of the problem is with management, not workers or unions. They adopt a *no layoff* policy using 10% annual attrition to adjust workforces. They *flatten the organizational hierarchy* by getting rid of middle managers who cause *overcontrol.* They use *teamwork* in *task-oriented organizations* that change structures and procedures as tasks change -- *innovative organizations.* They champion *bottoms-up innovation as* "those at the top must often change the rules before those at the bottom can innovate." They improve the employee's situation which automatically improves productivity rather than efforts to improve productivity which "usually undermine both productivity and morale."

Examples: Desert Storm, quality management in municipal waste collection and motor vehicle maintenance, a Minnesota program designed to listen to employee ideas, and Pennsylvania's Ben Franklin Partnership. What not to do: central management of the Vietnam War and federal overcontrol of state and local government.

MARKET-ORIENTED GOVERNMENT shapes private conduct by a *noncentralist approach,* using market forces, *leveraging change through the market* rather than by establishing a program. *Structuring the market* isn't new. Government has always structured legal markets -- "Next time you hear someone condemn government and glorify the free market, ask him if he really means to hold the drug trade up as a model." Markets beat programs because programs are driven by constituencies not customers, by politics not policy, have turf, create *fragmented delivery systems*, aren't self-correcting, use commands rather than incentives, infrequently achieve appropriate scale, and rarely die.

Governments can *restructure the marketplace* by rules like zoning, providing consumer information, encouraging demand (e.g., vouchers), encouraging new supplies (*catalyzing private sector suppliers*). They can fill market gaps by actions like making loans to small business, encouraging new market sectors like HMOs, sharing risk with the private sector, mobilizing capital from pension funds, raising taxes to discourage use of alcohol and tobacco, and adopting user fees including peak-load pricing.

In regulation, government should apply *market-oriented thinking* rather than a *command-and-control strategy* that is slow, discourages innovation, is extremely expensive and inherently focuses enforcement on large organizations and on symptoms rather than causes. *Green taxes* (such as on pollutants emitted) are better than *all-or-nothing regulation*. *Restructuring markets within the public sector* is also appropriate.

Examples: emissions trading in pollution control, vouchers and tax credits for child care rather than funding day care centers, mandatory deposits on containers, no fault insurance, impact fees for developers, and taxes on pesticides and fertilizers in Iowa, Minnesota, and Oregon.

PREVENTION AND INVESTMENT

Taking The Long View: The concepts of spending to prevent future costs and investing for future benefits aren't new. They appear in the Puritan ethic, in advice of parents to children, in cost-benefit analysis, in public health doctrines, and elsewhere. They are a common theme of many new governors.

Prevention Versus Care: Many state officials are saying that priority should be given to preventive health relative to treatment. Typical statistics:

> It costs $100,000-200,000 to treat an AIDS case, but $10,000 to prevent one if a $10-per-person education program works in one of a thousand cases.
>
> Prenatal care costing $2,000 can often prevent birth problems ultimately costing $100,000 and more.
>
> Lifestyle changes, like diet and exercise, encouraged by health education can reduce (or at least postpone) the need for costly treatments.

State health spending is heavily oriented to treatment, not prevention. Medicaid hospital and nursing home spending exceeds other health care spending by a wide margin and is growing faster. In a January speech to the National Press Club, Governor Wilson used California's inability to find much money for prevention as an illustration of how federal mandates distort state priorities.

Governor Weld requested $24 million in his tight new budget for eight prevention initiatives. They include expansion of the WIC program, early intervention for disabled disadvantaged youth, more prenatal care, and several AIDS-related programs. The package also has new money for family planning centers losing federal funds because they won't follow the "gag rule" that prevents them from talking about abortion. Governor Wilson proposed a program (CHECK UP) for non-Medicaid children up to age five.

Investments: Governor Engler's budget places heavy emphasis on education, including "*investing* $3.5 billion in our K-12 schools." It describes the priorities used to determine the budget as including "building a foundation for the future" by maintaining the commitment to education and by repairing the state's aging infrastructure.

Investments in children are also characterized as the priority in the California and Massachusetts budgets. Encouraging business investment by tax policy and a favorable business climate figures prominently in the plans of these governors, and most others. Added public investment is a less prominent theme partly because these states are running out of borrowing power and have conventional demands, such as school construction in California, for their remaining borrowing power.

FINANCING HEALTH CARE

Introduction

There appears to be widespread agreement that paying for health care is one of the most, if not the most, pressing national policy issues. Increasingly, state officials are saying that individual states cannot go it alone with comprehensive health financing plans that deviate massively from the coverage and taxes of competing states. So, there appears to be agreement that there is a major federal role in the solution, though disagreement about what that role might be. However, there is also agreement that the chances of any Congressional action before the 1992 elections are between slim and none. It follows that if anything is to be done this year, it will likely be done in individual states.

Possible State Action

While federal action can be deferred indefinitely, as it has been for decades, officials of every state will have to face tough specific issues in 1992 -- financing Medicaid if nothing else. Officials in nearly every state are also trying to find some way to act quickly to deal with uncompensated care, or at least the piece of it that appears most dramatically to them. There are plenty of choices for that piece: (1) poor, non-Medicaid, children lacking preventive care, (2) persons who can't buy coverage at any reasonable price, (3) services they think should be covered but aren't, such as substance abuse, mental health, or mammograms, (4) threatened or actual hospital closings in central cities and rural areas, and (5) employers and health care providers complaining about the costs of uncompensated care which they must absorb.

The Anatomy of Cost Increases

New federal cost projections confirm the worst fears about rising health care costs. Total national health spending is expected to reach $810 billion in 1992, $3,057 per capita. The growth rate is predicted to be about 9.5% per year in the early 1990s. This compares with population growth of just under 1% and growth in the economy of 6-7% (unadjusted for inflation). Medicaid is predicted to grow at 15.5% per year through the early 1990s.

Sources Of Hospital Cost Increases, 1990-1995

External Factors	
General Inflation	44%
Population	11
Health-Specific Factors	
Extra Health Inflation	19
Longer/More Stays	9
Real Service/Day	17
Total Cost Escalation	100%

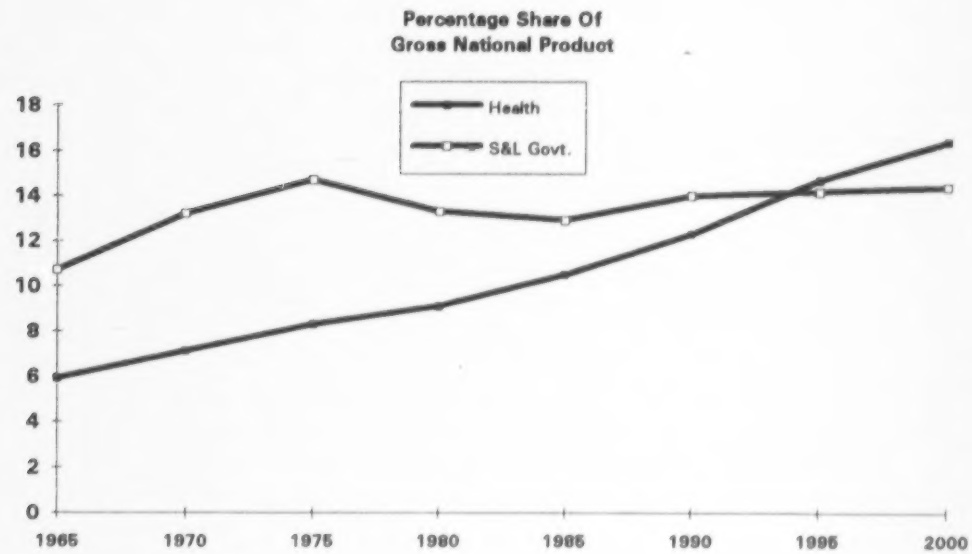
The projections are based on factors external to the health care system and factors within it. As shown at the left, over half the increase results from external factors -- price increases and population change, both the growth in population and its increasing average age. The rest of the increase is a result of people spending more time in the hospital, getting more intensive services while they are there, and the predicted continuation of price increases in health care that exceed price increases in the rest of the economy.

The federal projections suggest that governments will continue to pay an increasing share of the nation's health bill even without policy change. Government's share has risen from 25% in 1965 to 43% in 1991. It is expected to reach 47% by the year 2000. Most of the growth will be federal, as more and more people are covered by Medicare. The state and local (mostly state) share of the nation's bill is predicted to grow slowly from 13.3% in 1980 to 14.8% in 2000.

Health Costs Outpacing State And Local Government Costs

The rapid increases in health care costs make it inevitable that they will eventually exceed all the spending of state and local governments combined. This crossover point has just about been reached. The chart measures each as a percentage of gross national product.

State and local spending has been 13-15% of GNP since the 1970s. Because this spending tends to be more stable than the overall economy, the percentage is highest in recession years, like 1975, and lowest during rapid economic upturns. Health costs have been steadily rising as a share of national output. Many state officials have their own projections showing that, at the current rate of increase, Medicaid alone will start to use up all of the natural growth in state revenues.



Cutting Medicaid Services

Despite all the concerns about rapidly escalating Medicaid costs and the pressures on state finances, states generally *have not* been limiting the services provided under their Medicaid programs. The most costly services, such as in-patient hospital care and nursing home care, are mandatory under federal law. States have the meaningless option of dropping Medicaid entirely, but if they provide Medicaid they must include these services.

Cutting "optional services" is possible for some states, but others don't provide them or provide only a few. Part of the opposition to cutting them is simply the perception that they are more meritorious than whatever else might be on the chopping block. There is also the fear that eliminating Medicaid coverage won't eliminate the cost, just move it to another state or local program -- in the process switching from a 50-80% state and local share to a 100% state and local share.

Cuts are somewhat easier to make in Arkansas than in most states because of the state's long-established laws and traditions for adjusting spending to the amounts available. The budget is adopted in tiers with the first tier likely to be fundable regardless of revenue perturbations and the third representing "nice to have" spending that would only be made if revenues outran expectations by a wide margin. Within the middle ("B") tier, spending is adjusted administratively using a logic spelled out in the appropriations legislation.

In 1989, there were special restrictions such as those on the number of prescriptions. In July of 1991, the funding situation improved through bootstrap financing, which among other things permitted an increase in hospital rates. In December, cuts were announced to eliminate chiropractic services, physical therapy, private psychological care, and payments for certain equipment such as wheelchairs. There were new restrictions on the number of visits to doctors and hospitals and on available dental services.

The result was a well-publicized public protest in which 18 disabled people in wheelchairs chained themselves to the furniture in Governor Clinton's office. Some of the cuts were rescinded and a newly appointed task force is examining the issues.

The Uninsured

The statistics on Americans without health insurance coverage have been updated with discouraging results. Even counting Medicaid as insurance coverage and excluding all persons over-65 as having Medicare coverage, 35.7 million people lacked coverage in 1990. This represents an increase of 4% from 1989. From 1989 to 1990, 2.1 million *fewer* people had coverage from private health insurance but 3.1 million more were covered by Medicaid. The state statistics are shown below.

Percentage and Number (000) Of Non-Elderly Without Health Insurance, 1990

Rank	State	Percent	Number	Rank	State	Percent	Number	Rank	State	Percent	Number
1	New Mexico	26.4%	348	18	West Virginia	16.6%	258	34	Indiana	12.7%	604
2	Texas	24.1	3,618		**United States**	16.6	35,745	35	Kansas	12.6	273
3	Florida	22.9	2,445	19	Delaware	16.4	97	36	Pennsylvania	12.4	1,266
4	Mississippi	22.9	536	20	Montana	16.4	118	37	Ohio	12.1	1,151
5	Louisiana	22.5	804	21	North Carolina	16.2	892	38	New Jersey	11.9	800
6	Oklahoma	22.3	593	22	Maryland	16.0	661	39	New Hampshire	11.5	112
7	California	22.1	5,787	23	Tennessee	16.0	689	40	Massachusetts	11.1	559
8	Arkansas	21.1	436	24	Oregon	15.8	389	41	Vermont	11.1	55
9	Alabama	20.5	743	25	Kentucky	15.6	491	42	Michigan	11.0	895
10	Arizona	19.8	586	26	Missouri	14.6	680	43	Nebraska	10.3	142
11	Nevada	19.2	204	27	New York	14.4	2,250	44	Minnesota	10.2	394
12	South Carolina	18.9	564	28	Wyoming	14.4	60	45	Utah	10.2	160
13	Virginia	18.9	1,024	29	South Dakota	14.3	82	46	Iowa	9.8	233
14	Idaho	18.0	169	30	Rhode Island	13.9	111	47	Hawaii	9.2	82
15	Alaska	17.9	79	31	Washington	13.4	568	48	Wisconsin	8.6	350
16	Georgia	17.7	984	32	Illinois	13.2	1,352	49	Connecticut	8.5	238
17	Colorado	17.3	506	33	Maine	13.2	143	50	North Dakota	8.2	44

The highest percentages of those without health insurance are found in Southern states. They combine two determining characteristics: (1) a high percentage of low-income households and (2) a Medicaid program with strict eligibility standards.

Taxing Health Care Providers

In those states that were heavily involved in bootstrap financing, this will be the year to move to compliance with the new federal rules. The politics of the move won't be easy. For example, Alabama raised nearly half of its Medicaid match from providers. Ninety-five hospitals with 2% or more of patients covered by Medicaid paid a special tax while the 28 other hospitals didn't participate. Now Alabama must cover the match with the general fund, an unlikely alternative, or make the provider tax legal by broadening it to all hospitals. The old plan was sold because the participants would gain, but this won't be the case for those hospitals newly taxed. Those hospital officials are unhappy. The Alabama Hospital Association, which supported the earlier plan, will probably be neutral on this one.

Fighting It Out In Virginia

Question: *What can be done to deal with health care problems?*

Answer: *First of all you're going to have to make some people mad.*

This was the beginning of Governor Wilder's response on a C-SPAN interview (2/3) which centered heavily on his new campaign, which began almost immediately after he dropped out of the Presidential sweepstakes. The Dominion State developments are significant for other states as indicative of the consequences when elected officials and health care providers part company on how to pay for Medicaid. Virginia is providing a preview of how provider tax issues may develop in states where providers are opposing the tax.

The current estimate for Medicaid cost increases in the new (biennial) budget is $743 million, of which half would come from state funds. The budget proposes that a portion of this be covered by provider taxes. Physicians would pay $200 per year. Other providers would pay on a tax base of gross receipts minus receipts associated with indigent care. The rate would be 0.8% for hospitals, 1% for nursing homes, and 0.5% for pharmacists. Providers don't like the idea, preferring that the funds come from general revenue, supplemented as necessary by higher taxes on alcohol and tobacco.

Freed from the constraints of a Presidential campaign by his decision to drop out, Governor Wilder is attacking provider opposition head on and publicly. At a hearing in January, he suggested overspending in health care, such as "the posh salons and furnishings that have turned some hospital units into resorts." He was critical of prices in hospital bills of common items (e.g., $5 for aspirin and $300 rent for a walker that can be purchased for $50) that exceed market prices. He also attacked "slick advertising," not-for-profit hospitals that make profits, and industry use of "high-priced lobbyists, scare tactics and catchy slogans."

He suggested providers could absorb the tax without increasing prices, even urging that passing along the tax to consumers be made a crime. He endorsed new regulatory activity including controlling hospital rates, executive salaries in the health care industry, and overcharges for drugs and supplies. He suggested reviving certificate of need procedures requiring state approval of major capital outlays such as CAT scan equipment.

The new levies like Virginia's probably won't be called taxes by those proposing them and probably won't even be called revenue enhancers. Virginia's is "Shared Provider Financial Participation."

Covering The Uninsured In Pennsylvania

Pennsylvania may be the exception to timidity among state officials in adopting potentially expensive new coverages in health care. Governor Casey has proposed a state-run, state-paid program to cover children in families too affluent to qualify for Medicaid and not "well off enough to pay for insurance of their own." This test will equate to about $40,000 in family annual income. Coverage would be available for every child in such families not covered by private insurance or Medicaid. As outlined, it would appear to cover all costs (e.g., medical, dental, drugs) without deductibles or copayments, but exclude the high end of costs, particularly hospitalization beyond 90 days. Opposition immediately appeared from those concerned that the state shouldn't be trying new initiatives while the governor is making administrative cuts in current ones and warning of possible fiscal problems.

The Outlook For State Action

It would be surprising if any state adopts comprehensive health care financing legislation in 1992. To be comprehensive such plans must do something about a state's share of the 36 million or so uninsured citizens. Substantial new state money for this coverage is part of the plans that are most acceptable to health care providers and private employers. But the states don't have that kind of money and aren't likely to try to raise it in 1992. Another choice is to make employers cover their own employees ("play"), or reimburse the state for covering them ("or pay"), plus help cover the unemployed uninsured and those employed by exempted small business employers. This choice is unacceptable to many employers not providing coverage and to some employers who do. The other enticing possibility is to pay for new coverage by "savings" from administration, utilization controls, and limits on how much providers are paid. That alternative is hard to package in a form acceptable to providers.

In simple terms, legislators are being given the election-year choice of: (1) doing nothing while agreeing that something should be done, (2) going to war with taxpayers, (2) going to war with employers, or (3) going to war with providers. The answer has consistently been coming up #1.

North Carolina's situation was recently assessed by the N.C. Center for Policy Research which concluded, "the best thing to do may be to encourage the states to experiment." There is a legislative study commission examining the subject, but it is not scheduled to report until 1993. Study commissions to report in time for action 1993 or later also represent the solution of choice for Iowa and will be for Colorado if the governor's recommendations are followed.

In a recent address to the Georgia legislature, Governor Miller conceded that making health care more affordable wasn't a major part of his agenda. Instead, he said the issue "largely must be addressed at the national level."

FISCAL CONDITIONS UPDATE

Though releases of bad news are common, **state fiscal conditions are even worse than they appear to be.**

The surveys released in January by the state budget officers and the National Conference of State Legislatures were filled with bad news -- more than half the states running current deficits, spending cutbacks, and poor outlooks for FY 1993. Since those estimates, many of which were made in November and December, revenue performance has been lackluster and more spending overruns have developed. These developments are understood in individual states, but not as a national phenomenon.

Major states, particularly **California** and **New York**, have not yet taken actions to deal with the deficits their governors announced in December. As California's Director of Finance put it, "the longer we wait, the larger the problem becomes." The bad news for the current year cascades into the FY 1993 budgets in the form of lower incoming balances (or higher incoming deficits), lower revenues as projected growth rates are applied to a lower base, and higher spending as projected growth rates are applied to a higher base.

California has the largest numbers, but its problems are found in many states. In early January, the governor proposed his $60 billion budget which was balanced without new taxes, but with many proposed spending cuts and tenuous reserves. In late January, the Commission on State Finance said the budget was out of balance by as much as $2.6 billion and, in a worst case scenario, by as much as $6 billion. The Finance Director conceded the problem:

> *The economic forecast which was used to prepare the budget was conservative relative to most private sector economists. But it now appears that actual economic conditions are worse than we projected.*

The governor reiterated his opposition to tax increases on top of the $7 billion in revenue increases last year. Instead he said, "We are probably going to have deeper cuts." This is still the response to worsening fiscal circumstances in all but a few states.

There is bad fiscal news even in states that recently raised taxes. **New Jersey**'s budget is tight for all the same reasons as other state's, plus the decision to earmark essentially all the new money from the large 1990 tax increase -- leaving tight situations in funding universities, Medicaid, and state operations.

Kentucky's massive 1990 tax increase was earmarked for education reform, but generated substantial surpluses because the tax increases took effect before the spending increases. By spending down the resulting surpluses in the current biennium, legislators left a big hole to fill in the biennium beginning in July. The recession dug the hole deeper by an estimated $60 million in FY 1991 and $170 million this year. With their statewide elections last November, state officials pushed many of their problems into the new budget to be considered this year. Now they must cope with scheduled increases in debt service, promised increases in school aid, and apparently inevitable increases in corrections and Medicaid. In his state-of-the-commonwealth address, newly inaugurated Governor Jones said, "Never before in our modern history have we faced a financial challenge of the magnitude of the one now before us."

Two of the largest 1991 tax increases were in **Connecticut** and **Pennsylvania**. Governors of both states have announced tight budgets for FY 1993. Pennsylvania is holding back spending administratively this year. Connecticut officials are looking at massive cuts in general assistance and cost-saving revisions in aid to local government.

Taking quick action to solve the problem doesn't seem to be solving the problem. **Florida**, **Georgia**, and **Illinois** legislatures acted this winter to rebalance their FY 1992 budgets. Shortly thereafter, new projections indicated that new budget gaps had opened.

In many states, nothing is happening and little is being said. Legislators and governors are waiting until closer to the beginning of the fiscal year to reassess their positions in light of whatever the economic outlook then appears to be.

TAX CUTS FOR BUSINESS

If we don't expand the job tax credit, South Carolina, with all its tax credits, will eat our lunch. We are in conversation with one of the major, major poultry processors in this country. One state is offering them a job tax credit, and we aren't in the county they are looking at. But this bill would change that.

This was part of the pitch Governor Miller offered the Georgia Chamber of Commerce in seeking support for his new business tax credit proposal. The credit would be $2,000 per job in the state's poorest counties, $1,000 a job in the 40 next poorest, and nothing in the rest. The proposal typifies the many business tax reductions being adopted in the name of economic development even in tight state fiscal conditions.

Polls indicate that jobs and the economy are of paramount importance to voters. Logic and experience indicate that jobs and the economy are critical to healthy growth in state and local revenues. So elected officials want to stimulate jobs -- more private sector jobs, not a larger public payroll. Direct grants to business often aren't attractive to firms or state officials because of possibilities for favoritism and manipulation, increasing on-the-books spending, and potential public opposition. By the process of elimination, business tax reductions to stimulate development emerge as an attractive policy.

The Massachusetts Cuts

Governor Weld's supply-side tax cut proposals include substantial business tax relief. Business would get, though only for one year, strong state tax incentives for creating new jobs. A new tax credit would offset up to 90% of the tax liability associated with new jobs and a possible additional 10% for employers providing job training and child care. In addition, there would be a "bonus tax credit" for investments in new plant and equipment. Along with the business tax cuts, the proposed cuts in personal income tax rates and capital gains (including basing the tax on the holding period) were offered as helping to improve the business climate.

If the legislature adopts these recommendations, Massachusetts could be the only state in the nation to make major tax cuts this year. If the Bay State can afford such cuts, then just about every other state can also. While there are signs that the state's downturn is bottoming out, its economy fell farther from previous levels than nearly any other state. Bond ratings remain the nation's lowest. A recent article in State Budget & Tax News (Issue 5) outlines a possible scenario of more fiscal troubles if the state yields simultaneously to forces for cutting taxes and raising spending.

As presented by the governor, the tax cuts would use about a third of the increases in revenue expected in FY 1993. From this perspective, they are paid for by revenue growth, not cuts in education or social programs. But major activities -- higher education, social services, and general aid to local government -- are budgeted for lower amounts than necessary to continue current services. From this perspective, critics see the plan as cutting into social services to make life easier for business.

Business Tax Reduction In Other States

Governor Castle has proposed that **Delaware**'s $250-per-job credit for hiring new employees be doubled -- tripled for firms that provide health care benefits. He also proposes to give individuals a tax credit of $15 for each $100 they invest in small businesses in four targeted industries. With new downward revisions in revenue estimates, the legislature will be trying to balance the budget with essentially no revenue growth in FY 1993. The governor contends the business tax reductions would pay for themselves with added revenues.

In **New Hampshire**, Governor Gregg wants to abandon the state's traditional resistance to aiding particular firms, which he calls *laissez faire*. In its place, he wants tax concessions targeted to firms willing to locate at a major air force base that is being closed. He would pay for these and other development ideas by business taxes, such as repealing an existing credit for job expansion or a new franchise fee.

In **Ohio,** Governor Voinovich proposed "no increase in major state taxes," but some "revenue enhancements" while suggesting that the state "look seriously" at a sales tax exemption for machinery and equipment purchased for research and development. In Pennsylvania, the Republican-controlled Senate has passed business tax cuts, including reducing the corporate income tax rate. While these aren't likely to succeed in the Democratic-controlled House, they are indicative of serious interest in business cuts.

Louisiana, like many states, routinely offered property tax exemptions for new investments in plant and equipment. Then-Governor Roemer, in a move that gained nationwide publicity as innovative, began conditioning the availability of tax exemptions on characteristics of individual businesses, such as how much pollution they caused.

Industry opposed the move as discriminatory against the Louisiana industrial base (e.g., petrochemicals) and reducing the likelihood of investment in Louisiana rather than other states which didn't follow the state's lead. Governor Edwards criticized the plan during his campaign and announced in January that the state will discontinue it.

Business Winning By Not Losing

If the objective of business is to lower the percentage of state and local taxes paid by business, tax cuts need not be a part of the strategy. The objective can be achieved if increasing state costs are covered by tax increases on individuals rather than business. Even larger reductions in business percentages occur if a tax increase on individuals relieves a tax on business, as when sales taxes on consumer goods and services are raised to relieve pressures on local property taxes. From this perspective, the lack of interest in business tax increases may be more significant than the interest in business tax reductions.

The recent National Conference of State Legislature's survey of legislative leaders (Leaders' Outlook) includes an assessment of the "relative likelihood of certain tax increases" this year. The greatest interest is in selective excise taxes like those on alcohol and tobacco, which NCSL sets at an index number of 100. In descending order, the less likely forms of state tax increases are expansion of the sales tax base (87), closing income tax "loopholes" (54), raising the sales tax rate (43), and raising the income tax rate (35). Raising business taxes (34) was the least probable of the increases considered.

Spending To Stimulate Business Location And Expansion

There are also spending proposals to encourage job creation. In **Delaware**, the governor wants a new fund for pay relocation costs of companies moving to the state as well as expansion of loan and training programs designed to help small businesses expand.

Many states are considering packages oriented to individual business decisions such as a new McDonnell Douglas plant, a maintenance facility for United Airlines, and many smaller facilities. Because General Motors has announced it is considering closing a plant in **Michigan** *or* one in **Texas**, state officials are competing with concessions to keep their plant open. These are but large examples of many situations involving fewer jobs, fewer competing states, and less publicity. New tax concessions, sometimes broader than the single plant-location decision motivating them, are being discussed in many of these cases.

In **Connecticut**, the governor's budget has more than a billion dollars in cuts to avoid another tax increase. But the budget includes $35 million to fund state financial aid to companies and legislation adopted in 1990 to assist manufacturers by giving local tax exemptions (with state reimbursement of lost revenue). His plan would also eliminate a surcharge on the corporate income tax, provide for reduced business property taxes in central cities, and enact tax exemptions for computer equipment, aviation fuel, and aircraft repairs.

INVESTING PENSION FUND ASSETS

Introduction

The **California** state and local employee pension plan (CalPers) announced in January that it was investing $225 million in loans to home builders to finance construction. In the announcement, the program was touted as offering: above-market rates of return (14-22%) and stimulation of the California economy by assisting in revival of the depressed housing construction industry. In the words of the controller, the plan provides "a happy coincidence of above-market returns and a strong economic stimulant." The announcement illustrates continuing issues in pension fund investment policy.

Social Investing

As pension fund assets build, controversy continues over whether any part of them should be invested for policy-related purposes such as stimulating the economy of a state, making loans to members of the pension system, or bailing out stressed local governments. Proponents of these policies often look to pension funds for money that can't be obtained other ways. Pension fund trustees typically contend that assets should be invested solely for the benefit of potential retirees, so lower returns and greater risk should be avoided.

As might be expected, instances of social investing have produced mixed results. The most notable losses have been in housing investments in **Alaska** and in development-oriented business investments in **Kansas**. Some of the successes include loaning money to New York City in the 1970s and home mortgage loans in **Hawaii**.

Pension officials risk adverse publicity regardless of the decisions they make on in-state investments. The **Kansas** investments have become a major scandal. **Michigan** has no such scandals, but pension investment policy was the subject of a major critical investigative report by the Detroit News (1/12). Pension managers are accused of neglecting Michigan, particularly Detroit, while investing in real estate in Honolulu. The state has more apartment investments in Las Vegas than Detroit, more real estate money in Sacramento than Lansing, and more big real estate deals in Texas than Michigan. Michigan is the primary owner of the Texaco Heritage Plaza in Houston where 3,500 people -- "many resettled from the Rust Belt states" -- now work.

Looking For Safe Social Investments

A common practice is finding investments that appear to offer both market rates of return given the risk *and* the appearance of stimulating the local economy. Examples: (1) purchase of publicly traded stock of companies with operations in a state and (2) purchase of portfolios of loans secured by in-state home mortgages.

California's Treasurer recently announced a plan to purchase loans on California homes guaranteed by the Federal National Mortgage Association and to purchase loans previously made to California small businesses guaranteed by the Small Business Administration. She has legislation pending to purchase farm export loans guaranteed by the Commodity Credit Corporation. Her announcement of the new purchases epitomizes the "best of both worlds" approach:

> *These investment strategies will produce safe, prudent, and attractive returns for California. And, just as important, they will help fill financial voids that have hurt home buyers, farmers, and small businesses.*

The **Massachusetts** Treasurer recently announced a similar, but more complex, program of investing in small business loans originally made by banks that have failed. The portfolio will have back up guarantees from successors of the original lenders and the Small Business Administration. **Pennsylvania**'s treasurer has a plan that provides financing for the period before new homeowners assume ownership under an arrangement of the Pennsylvania Housing Finance Agency that amounts to lease-purchase. Part of Governor Casey's proposals for job creation include putting a larger portion of pension fund investments in Pennsylvania.

Because there is no agreed definition of social investing, there are no reliable statistics on how much is being done or how successful it has been.

Risk And Return In Pension Investing

State plans on average are more risk-averse than private plans, investing a lower portion of portfolios in stocks and a larger portion in U.S. government bonds and notes. The investment strategies of state pension plans vary considerably in their tolerance for risk. Some, like CalPers, have long included significant components of risky investments that promise high returns, but as part of a balanced portfolio strategy that includes some lower yielding more secure investments. Some states avoid certain types of risky investments (e.g., small company stocks, low-rated bonds) entirely.

Investing in construction loans to developers is traditionally a high-risk, high-return business compared with loans to homeowners. Construction loans that went sour have much to do with the demise of many banks and S&Ls. This will deter pension managers in most states from following the California lead.

Risk, Return, And State Budgets

In the last several years, many states have used pension plans as a way to help balance budgets. The investment earnings of the plans, such as 8-19% on bonds and 12-20% on stocks, were far in excess of the returns of 5-8% assumed in actuarial calculations. State officials took advantage of this situation by lowering the percentage of payroll contributed to the plans and, in some cases, deferring the employer contribution. These actions were a major part of California's budget balancing last year and have helped New York for several years.

Under current conditions, this strategy appears much more risky. Pension plan investment assumptions have been increased, generally to the 7-9% range. Investment yields have declined to under 8% for federal long-term bonds, slightly more for corporate bonds, under 6% for short-term federal securities, about 3% for stock dividends, and, as usual, an unknown amount for stock appreciation.

TECHNICAL NOTES

Entrepreneurial Government: Generally accepted economic concepts underlie Reinventing Government, but there are lapses in applying them. In discussing "command-and-control" regulation of pollution, the authors are sensitive to costs government imposes on the private sector. In other discussions, such as saving fire department costs by requiring sprinklers, they aren't sensitive to total costs. They don't use "opportunity costs," so discussions like one lauding a city for buying a theme park are incomplete.

Many of the book's generalizations beg for elaboration. For example, private fire companies are lauded for encouraging fire prevention but private garbage companies are criticized for resisting efforts to reduce garbage generation. Because universal health coverage without rationing will increase costs, Osborne's *management* recommendations on health care are also *resource allocation* recommendations requiring that more money go to health and therefore less to private consumption and/or other public spending. Whether this is desirable is more than a management question.

Linking budgets and performance measures is an old idea, reflected in program budgeting systems used in many states. Asking whether something is worth doing at all before talking about how much to spend is the concept of zero-based budgeting. The alternative is a non-zero base like last year's budget or last year's with more or less money. Everyone would agree that state officials should periodically ask whether to have parks. Nearly everyone would agree they don't need to remake that decision each year, but do need to consider incremental changes in park budgets relative to competing uses of funds.

Governor Carter adopted zero-base budgeting in Georgia. By the time his consultants published their book, the Georgia base wasn't zero but 5-10% less than last year. Osborne's book calls zero-base "too cumbersome" but says Phoenix has "a successful modification" -- looking at 10% cuts (a 90% base). Governor Weld is touting zero-base budgeting, looking at whether programs are worth continuing, a true zero-base.

Health Care: Health cost projections are from the Health Care Financing Administration (Health Care Financing Review, (Fall 1991). State and local percentages of GNP come from ACIR's Significant Features Of Fiscal Federalism. **Reports** projected 14.2% for 1995 and 14.5% for 2000. The N.C. Center (P.O. Box 430, Raleigh, NC 27602) study of health options appears in the its North Carolina Insight (November 1991).

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